

No. 15207

**In the United States Court of Appeals
for the Ninth Circuit**

C. H. WENTWORTH, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT
OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 15-25) are reported in 25 T. C. 1210.

JURISDICTION

The taxpayer's petition for review involves a deficiency in individual income tax in the total sum of \$60,902.38, as determined and asserted by the Commissioner for the taxable year 1947. (R. 3, 27-31). On August 24, 1953, the Commissioner mailed a statutory notice of such deficiency to the taxpayer. R. 6-9.) Within 90 days thereafter, on November 16, 1953, the taxpayer, pursuant to Section 272 of the Internal Revenue Code of 1939, filed a petition in the Tax Court for redetermination of this deficiency. (R. 3,

4-9). The decision of the Tax Court was entered on March 14, 1956. (R. 3, 26.) On June 7, 1956, the taxpayer filed his petition for review invoking the jurisdiction of this Court under Section 7482 of the Internal Revenue Code of 1954. (R. 3, 27-32.)

QUESTION PRESENTED

The taxpayer's corporation in 1944 credited the accounts receivable account of the taxpayer, its controlling stockholder, for \$180,000, and debited its capital account for the same amount. Its earned surplus account showed a credit balance of \$171,920.38 on December 31, 1944, and a credit balance of \$82,522.06 at the end of the taxable year 1947. The corporation was indebted to the taxpayer on two \$100,000 notes, both overdue and payable at the time this particular credit was made in 1944 to his accounts receivable account on its books.

The question presented is whether the Tax Court correctly held upon these facts that the corporation's credit to the taxpayer's accounts receivable account in 1944 effected in turn a corresponding offset in the corporation's notes payable account, representing its notes then overdue and owing to the taxpayer and, therefore, the corporate distribution of \$200,000 received by the taxpayer in 1947 constituted a taxable dividend to the extent of the corporation's earnings and profits in that year, instead of the payment by the corporation on its note indebtedness to him, as the taxpayer contends.

STATUTE AND REGULATIONS INVOLVED

These are printed in the Appendix, *infra*.

STATEMENT

The facts, as stipulated (including exhibits) (R. 11-14), were found by the Tax Court accordingly, substantially as follows (R. 16-19):

The taxpayer is an individual with a principal office at 1700 East Olympic Boulevard, Los Angeles, California. His original and amended income tax returns for the calendar year 1947 were filed with the then Collector of Internal Revenue for the Sixth District of California. (R. 16.)

On January 1, 1943, the taxpayer transferred to a newly formed corporation, the Flexo Manufacturing Company, Inc. (hereinafter called "corporation"), substantially all of the assets of a sole proprietorship business carried on by the petitioner under the firm name of Flexo Manufacturing Company. The assets so transferred were as follows, shown at cost (R. 16):

Cash in Bank	\$12, 704. 63
Accounts Receivable	105, 922. 97
Inventory	55, 685. 71
Furniture	286. 67
Machinery and Equipment	18, 073. 64
Auto and Equipment	3, 235. 30

The following liabilities and reserves were also transferred by the taxpayer to the newly formed corporation (R. 17):

Accounts Payable	\$10, 793. 54
Reserve for Federal Old Age Benefits Tax	272. 40
Reserve for Federal Payroll Excise Tax	108. 40
Reserve for California Unemployment Insurance Tax	503. 83
California Sales Tax	6. 10
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Reserve for Depreciation Machinery and Equipment	7, 836. 81
Reserve for Depreciation Autos and Equipment	3, 235. 30

The transfers of the assets, liabilities and reserves by the taxpayer to the corporation resulted in a capi-

tal contribution to such corporation, on a book basis, in the amount of \$152,737.44. (R. 17.)

The taxpayer received from the corporation, in exchange for the transfer, 120,830 shares of stock with a par value of \$1 per share, of which he transferred five qualifying shares to Robert Steele. The stock was issued on September 26, 1944. The corporation sold 4,167 shares of stock for cash to Lloyd Wallmer, making a total of 124,997 shares of stock outstanding. (R. 17.)

An open account in taxpayer's name was maintained on the books of the corporation with the heading "Accounts Receivable—C. H. Wentworth." On February 27, 1943, this account had a credit balance of \$2,197.20. On that same date the taxpayer advanced \$100,000 to the corporation and received a note in the face amount of \$100,000, maturing in one year and bearing 6% interest. On April 14, 1943, the open account had a credit balance of \$3,397.20, and on the same date the taxpayer advanced an additional \$100,000 to the corporation, receiving back an additional note in the face amount of \$100,000, also maturing in one year and bearing interest at 6%. Both notes were carried on the corporate books as "notes payable." On December 31, 1943, the open account on the corporation's books in the taxpayer's name reflected a debit balance of \$197,211.03. (R. 17-18.)

On October 31, 1944, the taxpayer's open account had a debit balance of \$200,742.60. The corporation on that date credited the open account with \$180,000, leaving a debit balance in the account of \$20,742.60, and at the same time charged its capital account, which

resulted in a capital deficit of \$23,095.56. No charge or entry was made to the notes payable account, nor were the notes payable in the amount of \$200,000 canceled. (R. 18.)

No income was reported by the taxpayer on his individual income tax return for the calendar year 1944, or for any other year, as resulting from the credit of \$180,000 made by the corporation to his open account. The taxpayer did not exchange any stock with the corporation or surrender any stock to the corporation, nor has there been any liquidation or partial liquidation of the corporation. (R. 18.)

On December 31, 1943, the earned surplus account of the corporation showed a credit balance of \$114,322.19, and on December 31, 1944, the credit balance in this account was \$171,920.38. The earned surplus of the corporation, on December 31, 1947, was \$82,522.06. (R. 18-19.)

In May, 1947, the corporation distributed to the taxpayer the sum of \$200,000. At the same time, the taxpayer surrendered to the corporation the two notes of the corporation made out in 1943 and maturing in 1944. The notes payable account on the corporation's books was debited with the amount of \$200,000, and the notes were canceled. (R. 19.)

On the basis of these facts, the Tax Court, sustaining the Commissioner's determination (R. 6-9), held that the corporation's payment to the taxpayer by the credit to his accounts receivable account in 1944 effected a corresponding offset in its notes payable account representing its note indebtedness then overdue and owing the taxpayer, and therefore the cor-

porated distribution of \$200,000 to the taxpayer in the taxable year 1947 was a taxable dividend to the extent of its earnings and profits in that year, and not the payment by the corporation of its note indebtedness to him (R. 19-24). The Tax Court thereupon entered its decision accordingly (R. 26), from which the taxpayer petitioned this Court for review (R. 27).

SUMMARY OF ARGUMENT

To support his contention that the Commissioner and the Tax Court erred, taxpayer relies solely upon entries made upon the books of the corporation of which taxpayer was the principal stockholder, and which he dominated and controlled. The undisputed facts show that the book entries are totally unreliable; and the Tax Court was fully justified in finding upon the agreed facts that the corporation's one-year notes given to taxpayer in 1943 were paid off by the corporation in 1944 to the extent of \$180,000, the amount by which taxpayer's open account was credited on its books at a time when the notes were due. Hence, it follows that the notes could not have been paid off in 1947, as the taxpayer contends.

ARGUMENT

The cancellation of the taxpayer's indebtedness to his controlled corporation in 1944 effected in fact the cancellation in like amount of the corporation's note indebtedness then owing, overdue and payable to him, and therefore the corporate distribution to the taxpayer in 1947 constituted a taxable dividend to him, and not the repayment of loans

The sole question presented for decision is whether the \$200,000 distribution received by the taxpayer in

the taxable year 1947 from his corporation of which he was the controlling and dominating stockholder constituted a taxable dividend to him to the extent of the corporation's earnings and profits at the end of that year, or was in payment of two notes of the corporation for \$100,000 each which were given him in 1943, and which were overdue in 1944 when an entry was made upon the corporation's books crediting taxpayer's open account with \$180,000.

The question actually narrows itself to one of whether the \$180,000 credit to the taxpayer on the corporate books in 1944 was in reality a distribution to him of earned surplus. The taxpayer admitted below (R. 21), and at least tacitly admits here, that this credit in 1944 had to be treated either as a distribution of earned surplus or as a payment on the two notes. Thus, his contention here that the credit was not a payment on the notes is an assertion that it was a distribution of earned surplus in that year. To support his contention he relies solely upon the bookkeeping entries made by the corporation, a corporation which he dominated and controlled. The most cursory examination of the admitted facts shows that the bookkeeping entries were unreliable. As of October 31, 1944, the corporation credited taxpayer's accounts receivable account with \$180,000, and in turn debited its *capital account* in the same amount, thereby admittedly improperly effecting a capital deficit exceeding \$23,000 on its books. There is no showing that the corporation declared any dividends, and the taxpayer reported no income on his returns

as resulting from the transaction. The offsetting entry in the capital account would have been proper only if it represented a redemption of stock or as a result of a liquidation or partial liquidation of the corporation. Taxpayer admitted that there was no cancellation of stock or planned liquidation. At the time these entries were made the taxpayer owed the corporation \$200,742.60 (R. 18); and taxpayer held two *overdue* notes of the corporation, each for \$100,000.

Bookkeeping entries are not conclusive. *Helvering v. Midland Ins. Co.*, 300 U. S. 216; *Doyle v. Mitchell Brothers Co.*, 247 U. S. 179, 187; *Royal Packing Co. v. Lucas*, 38 F. 2d 180 (C. A. 9th). Yet, taxpayer's case is bottomed upon the bookkeeping entries above referred to, and especially upon a negative entry. That is, that no charge or entry was made to the notes payable account to taxpayer; and the fact that the notes were not cancelled in 1944. However, in view of the taxpayer's domination of the corporation, the unreliability of the book entries, the fact that the taxpayer returned none of the \$180,000 as income in 1944, the fact that the corporation was indebted to taxpayer and the taxpayer to the corporation, and the fact that the corporation had never declared a dividend, it seems clear the Tax Court was fully justified in finding the entries unreliable and in finding that the credit in 1944 was not intended as a distribution of earned surplus. As the Tax Court said (R. 23):

If he had wanted the books to show a dividend payment to him he could have caused the books

to show the usual entries that record distribution of dividends. We are not so naive as to think petitioner would ever claim the unclear book entries show a dividend distribution to him, were it not for the fact the income tax on such distribution is now barred.

The Tax Court's finding that the credit was not a dividend, upon the taxpayer's own admission, leaves as the only alternative the conclusion that it was intended as a payment toward the notes. Indeed, in an arms-length transaction, it is difficult to conceive why a corporation, while owing a stockholder \$200,000, would credit that stockholder with \$180,000 toward \$200,000 which the stockholder owed to it. It certainly would serve no corporate business purpose. Nor can one find any business purpose in the corporation's debit of its capital account (to a minus) at a time when the corporation had a large earned surplus. Clearly, the bookkeeping entries are unreliable, and the Tax Court was fully justified in taking into consideration admitted facts in making its finding that the credit was a payment on the corporation's notes payable to taxpayer. See *Fisher v. Commissioner*, 7 B. T. A. 968. Cf. *Gulf Oil Corp. v. Lewellyn*, 248 U. S. 71.

We submit the Tax Court's ruling is not based upon any theory of equity or estoppel. In the circumstances of this case, when dealing with totally unreliable book entries made in transactions between the corporation and the taxpayer, who controlled it, we submit the fact that the taxpayer did not report any part of the \$180,000 credited to him in 1944, is itself

evidence that he did not intend that it be a distribution of dividends to him in that year. And we believe that the Tax Court properly considered this as a fact with other admitted facts in reaching its conclusion. That the Tax Court considered it as a fact is made clear from the following excerpts from its opinion, where it found (R. 21-22):

Since the offsetting entry—the debit to the capital account [in 1944]—does not clearly reflect what actually occurred, we have a right to look at other facts * * *. * * * this corporation, almost wholly-owned and controlled by petitioner, had never declared any dividends. There was another stockholder holding 4,167 shares, who received nothing if the major portion of the \$180,000 credit is called a dividend. * * * the fact that a payment is made to one and not the others militates against its being called a dividend when it can fairly be explained it is not.

* * * * *

Do his [taxpayer's] actions show he treated it [\$180,000 credit in 1944] as a distribution of dividends? Clearly they do not. He did not report it as dividend income in his income tax return for 1944. All of his actions are consistent with the receipt of the \$180,000 as payment on his notes [in 1944] and inconsistent with his treatment of the payment as income to him.

Further (R. 23-24):

There is nothing in the record to show petitioner was unfamiliar with the income tax laws. * * * and he wants us to conclude the next year [after incorporation] he took \$171,920.38 worth

of earnings from his business and paid no tax. * * *

Under all of the special facts of this case we find the petitioner did receive payment on his notes in the sum of \$180,000 on October 31, 1944. Therefore the distribution of \$200,000 in 1947 to the petitioner resulted in a taxable dividend to him of \$82,522.06, the amount of the corporation's earnings and profits at the end of that year.

These findings are entitled to finality where, as here, they are supported by substantial evidence and are not shown by the taxpayer to be clearly erroneous. *United States v. Gypsum Co.*, 333 U. S. 364, 394-395, rehearing denied, 333 U. S. 869. "Here, the decision below was consistent with the findings which on the evidence were well within the province of the trier" of the facts. *Chesbro v. Commissioner*, 225 F. 2d 674 (C. A. 2d).

Although, as above demonstrated, the Tax Court did not treat the fact that the taxpayer returned no income from the 1944 transaction as an estoppel or anything in the nature thereof, but merely as a fact to be considered with other facts, it should be pointed out that there is reputable authority for the proposition that by failing to report he thereby declared, in effect, that no income had been received by him. *Crane v. Commissioner*, 68 F. 2d 640, 641 (C. A. 1st); *Bothwell v. Commissioner*, 77 F. 2d 35 (C. A. 10th); *Fordyce v. Helvering*, 78 F. 2d 525 (C. A. 8th). And see *Ross v. Commissioner*, 169 F. 2d 483, 495 (C. A. 1st), wherein in an opinion written by Mr. Justice

Frankfurter, sitting as a circuit justice, the *Crane* case was approved and distinguished.

Viewing the situation here from the standpoint of substance, as we must in determining questions of federal taxation (*Weiss v. Stearn*, 265 U. S. 242), we submit that the Tax Court was correct in concluding that the \$180,000 bookkeeping credit in 1944 was not a distribution of earnings, but was a payment to the taxpayer on his then overdue notes of \$200,000.

CONCLUSION

The decision of the Tax Court is correct and should therefore be affirmed by this Court.

Respectfully submitted.

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DECEMBER, 1956.

APPENDIX

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(a) *Distributions by Corporations.*—Distributions by corporations shall be taxable to the shareholders as provided in section 115.

* * * * *

(26 U. S. C. 1952 ed., Sec. 22.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) [As amended by Sec. 166, Revenue Act of 1942, c. 619, 56 Stat. 798] *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 201 (c) (5), section 204 (c) (11) and section 207 (a) (2) and (b) (3) (where the reference is to dividends of insurance companies paid to policy holders)) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), with-

out regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions*.—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113. * * *

(c) [As amended by Sec. 147, Revenue Act of 1942, *supra*] *Distributions in Liquidation*.—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. In the case of amounts distributed (whether before January 1, 1939, or on or after such date) in partial liquidation (other than a distribution to which the provisions of subsection (h) of this section are applicable) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits. * * *

* * * * *

(26 U. S. C. 1952 ed., Sec. 115.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.22 (a)-1. *What Included in Gross Income*.—Gross income includes in general compensation for personal and professional serv-

ices, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. * * *

* * * * *

SEC. 29.115-1. *Dividends*.—The term “dividend” for the purpose of chapter 1 (except when used in section 201 (c) (5), section 204 (c) (11), and section 207 (a) (2) and (b) (3) where the reference is to dividends of insurance companies paid to policyholders) comprises any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of either—

(1) earnings or profits accumulated since February 28, 1913, or

(2) earnings or profits of the taxable year computed without regard to the amount of the earnings or profits (whether of such year or accumulated since February 28, 1913) at the time the distribution was made.

The earnings or profits of the taxable year shall be computed as of the close of such year, without diminution by reason of any distributions made during the taxable year. For the purpose of determining whether a distribution constitutes a dividend, it is unnecessary to ascertain the amount of the earnings and profits accumulated since February 28, 1913, if the earnings and profits of the taxable year are equal to or in excess of the total amount of the distributions made within such year.

* * * * *

A taxable distribution made by a corporation to its shareholders shall be included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands.

* * * * *

